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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

International Finance Series, No. 7

The World Gold Market

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
22 October 1968

INTELLIGENCE MEMORANDUM

International Finance Series, No. 7

The World Gold Market

Summary

During September 1968, another French gold sale of $85 million left the United States with a net gain of $73.5 million for the month. Purchases from the United States in September were $11.5 million, the lowest since establishment of the two-tier market in mid-March. Argentina, with a purchase of $5 million, was the biggest buyer.

Increasing confidence in the world monetary system appears to be at least partly responsible for the steady decline in demand for US gold. In early October, Argentina bought another $5 million but this was offset by a Philippine sale of an equal amount to the US. At the end of the first week in October only one sale of US gold -- another $5 million to Argentina scheduled for early November -- was anticipated for the remainder of 1968.

The French sale in September brought to $460 million the total France has sold to the United States since mid-May and enabled the United States to show a net gain of $53 million in its gold position for the second and third quarters of 1968. As a result of their domestic crisis, the French saw their gold reserves reduced by $1.07 billion between mid-May and late September.

Reexamination of South African statistics on gold reserves and gold production reveals that for the first three quarters of 1968 the South Africans sold $330 million worth of gold, roughly 25 percent

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research.

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of which left South Africa in the first quarter, prior to establishment of the two-tier system. From mid-March to early June, the South Africans withheld gold from the free market. Subsequent sales during June were only $62 million, including $42 million sold to France and the United Kingdom for repurchase of Rand obtained through IMF drawings. Third-quarter sales were $175 million, mainly to Swiss commercial banks and the Portuguese Central Bank, and accounted for more than half of total 1968 sales to date.

South Africa's ability to limit its gold sales has been increased by the nation's relatively favorable balance of payments compared with previous years. The trade deficit has been smaller, while capital inflows have been larger than normal. The non-gold balance of payments has begun to worsen, however, and South Africa will have to sell additional amounts of gold in the fourth quarter of 1968 unless it is willing to run up short-term debts to foreign banks.

Previous issues in this series have featured background sketches on major world gold markets. This issue focuses on the organization and operations of the Hong Kong-Macao market, the smallest and most complex of the major gold markets. Hong Kong is a principal financial and commercial center in the Far East, a status uniquely suiting it for primacy in the regional gold trade. However, its government permits gold imports only for purposes of re-export and only if such reexports comply with import regulations of the countries of destination. Hence, in order to obtain gold for use in the Far Eastern smuggling trade, dealers engage in a complex system of legal reexports to Macao, where gold is recast into smaller bars and then returned to Hong Kong illegally via a well-established smuggling net. The overt stage of legal import and legal reexport of gold to Macao -- which amounts to between 3.3 and 5.0 tons per month -- is undertaken by firms associated with well-known names in the world gold trade. The Macao operation, on the other hand, is undertaken by a syndicate composed of persons of more clouded reputation, while the smuggling trade out of Hong Kong to customer areas in the Far East (primarily Japan, India, and Indonesia) is handled by a number of persons and groups about which relatively little is known.

The Official Market for Gold

1. During the month of September, another French sale of gold to the United States of $85 million (see Table 1) more than offset US official sales of $11.5 million, which is the lowest monthly level of US sales since the establishment of the two-tier system in March 1968. Argentina, with a purchase of $5 million, led the list of buyers. Malta and Burma, desiring to reduce their sterling balances, each acquired $2.5 million. In early October, Argentina purchased an additional $5 million, whereas the Philippines sold an equal amount to the United States. The only transaction presently anticipated for the remainder of 1968 is another $5 million sale to Argentina scheduled for early November. Previously reported orders, which totaled $124 million, of which $95 million came from Portugal, have been cancelled.

2. The French sale of $85 million during September brings to $460 million the amount of gold sold by France to the United States since the French domestic crisis erupted in mid-May. These sales enabled the United States to show, on balance, an increase of $53 million in its gold stock since the end of the first quarter of 1968. France, on the other hand, has seen its gold reserves depleted by $1.07 billion between mid-May and the end of September. On 30 September, French gold reserves stood at $4.16 billion.

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The Free Market for Gold

4. During the first half of September, prices in London and Zurich continued a climb that had begun in late August. By mid-month, gold in London was selling at $40.55 while in Zurich the price reached $40.65 per troy ounce. These prices generally prevailed until just prior to the annual meetings

of the International Monetary Fund (IMF) and World Bank (IBRD), when speculators, apparently concerned about the possibility of a settlement with South Africa, unloaded abnormally large amounts onto the market. Within less than a week, the London price dropped $2.25 to $38.30, the lowest level in more than two months. At that price, however, industrial users and others quickly entered the market to build up inventories, and the price recovered to $39.80 by Monday, 7 October. The same pattern was evident in the Zurich market. (Weekly ranges of gold prices in London and Zurich are shown in Table 2.)

<u>Review of South African Gold Sales During 1968</u>

5. A reexamination of official South African statistics for the first three quarters of 1968 shows that the South African Reserve Bank sold approximately $330 million* worth of gold or nearly $500 million below the normal level of gold sales for comparable periods in recent years. A month-by-month estimate for 1968 reveals sales of $71 million in January and February and an additional $22 million in March (Table 3). Probably all of the gold sold during the first quarter went to London under the arrangements existing prior to establishment of the two-tier market. No sales were made in April, and only small amounts, if any, were sold during May. In June the South African Reserve Bank sold $42 million to the central banks of France and the United Kingdom to redeem an equal amount of its own currency issued as part of previous French and UK drawings on the IMF. The residual of $20 million sold in June is part or perhaps all of the free market sales announced in mid-July by Minister of Finance Diederichs as having occurred during May and June.**

* *All gold values are expressed in terms of $35.00 per ounce. The South Africans actually value their own reserves at a statutory rate of 24.8 Rand per ounce, equivalent to $34.72 per ounce at the official Rand/Dollar rate of 1 Rand to $1.40.*

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6. During the third quarter of 1968 the South African Reserve Bank apparently sold $175 million in gold, as revealed by a comparison of estimates of gold production and data on changes in South African gold reserves. [redacted] 25X1 25X1

25X1 [redacted] The Portuguese Central Bank purchased a total of 100 tons worth nearly $113 million, whereas the consortium headed by the three major Swiss commercial banks took slightly over $54 million.*

7. Although the difference between implicit South African sales and those positively confirmed amounts to only $8 million on a net basis for the third quarter as a whole, month-by-month comparisons show wider discrepancies. Confirmed sales were smaller than implicit sales in July by $29 million and exceeded implicit sales by $13 million in August and by $8 million in September. These discrepancies probably cannot be explained by monthly variations in gold production. In the past, such variations have been very small -- on the order of $1 million. The discrepancies could be the result of changes in inventories of refined gold held by the Chamber of Mines,** and/or of incomplete information on specific gold sales. The latter possibility appears to be remote for August and September because known sales exceeded the implied total in both months. It is possible that there were some unreported sales in July. Accumulation of some gold inventories by the Chamber of Mines makes sense, if there is any intention of initiating direct export of gold by this organization in the future (see paragraph 10 below).

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*** The Chamber of Mines is owned jointly by the seven South African mining companies. It coordinates industry policy through its refining and marketing operations for which it is given sole responsibility. At the mine facilities, gold is smelted into bars containing 85 to 90 percent pure gold and is then shipped to the Chamber's Rand refinery at Germiston, near Johannesburg, where it is refined into 12 1/2 kilogram bars containing 996 parts per thousand pure gold. The Chamber then sells the refined bars to the South African Reserve Bank.*

8. South Africa's ability to hold its gold sales far below normal has been greatly enhanced by the sharp improvement in other components of its balance of payments. Normally, South Africa must export virtually all of its newly mined gold to offset substantial deficits on current account. During the first half of 1968, however, capital inflows were much larger than normal and the trade deficit (excluding gold) was smaller than normal. The net capital inflow totaled $178 million in the first quarter and $110 million in the second quarter, compared with a quarterly average of $47 million last year. South Africa received long-term loans from Switzerland and a substantial inflow of funds from the United Kingdom, much of which represented purchases of gold mining shares. The reduction in the trade deficit from a quarterly average of $237 million in 1967 to $115 million a quarter in the first half of 1968 reflects a boom in agricultural exports as a result of favorable weather and a drop in imports, stemming mainly from a slowdown in investment activity. As a result of these favorable trends, the combined current and capital accounts (excluding gold) were nearly in balance in the first quarter and were in deficit by only about $100 million in the second quarter. This deficit increased to an estimated $210 million in the third quarter as a result of a drop in both non-gold exports and the capital inflow. But for the first three quarters combined, the balance-of-payments deficit (excluding gold) is slightly smaller than gold sales. Gold sales were greatly in excess of the deficit in the first quarter and did not cover the deficit in the second and third quarters. On balance, the net foreign exchange assets of the South African banking system have hardly changed since the beginning of the year.

9. South Africa's balance of payments is likely to deteriorate during the fourth quarter. Nevertheless, Finance Minister Diederichs is correct in his recent statement that there is no necessity for South Africa to sell gold in the near future, if the South Africans are willing to finance their deficit by moderate external borrowing. Exports are expected to decline

as agricultural stocks accumulated from the record crops in 1967 are drawn down. The capital inflow had already tapered off in the third quarter and is not likely to rebound in the fourth quarter. Without any gold sales, the balance-of-payments deficit for the fourth quarter is forecast to reach at least $235 million. Such a deficit, however, while it exceeds South Africa's 1 October foreign exchange holdings of about $210 million, could easily be financed through loans from foreign banks. Indeed, South Africa could finance deficits of this magnitude for a considerable time in this manner, if it wished to do so.

10. Nevertheless, it seems likely for several reasons that South Africa will sell gold during the final quarter, following the same judicious procedure it has exercised since March 1968. The arrangement offered by the consortium headed by Swiss banks is still available as a convenient channel for sales to the free market. Finance Minister Diederichs and Governor DeJongh of the South African Reserve Bank are returning to South Africa from the IMF/IBRD meetings via Western Europe. Their agenda includes informal discussions with a number of European commercial bankers and undoubtedly the subject of South African gold will loom large in the talks. Finally, since mid-August, government officials and members of the Chamber of Mines have been seriously examining possible courses of action not previously considered, in particular selling gold outside the European markets. Outlets under consideration include the Middle East (probably both Beirut and Dubai), India, and the Far East, particularly Hong Kong.*

* *Because of the covert nature of these markets, the South African Reserve Bank probably will avoid direct involvement in Middle Eastern and Far Eastern gold sales, preferring to let the Chamber of Mines conclude all transactions. Under South African law the Chamber of Mines is obligated to offer all newly mined gold to the South African Reserve Bank, but the Reserve Bank is not required to accept all gold*
(footnote continued on page 10.)

The Hong Kong-Macao Gold Market

11. Outside Europe, Beirut and Hong Kong-Macao stand out as important gold trading centers. Both are entrepots for extensive smuggling nets, extending throughout the Middle East and the Far East, respectively. The organization and operation of the Beirut gold market were examined in a previous issue in this series. [redacted] 25X1

12. The Hong Kong-Macao market is considerably more complex and less well-known than its Lebanese counterpart. It owes its present status to a Hong Kong governmental regulation of October 1953 which authorizes the import of gold only for reexport within a specified time, providing that the reexports comply with the import licensing requirements of the countries of destination. Under this regulation, the unique "twist" in this market has emerged. Gold is legally imported into Hong Kong and legally reexported to Macao, where it is recast into smaller bars. [redacted] 25X1

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offered. Information collected to date, however, gives no indication that the Reserve Bank has ever refused gold offered to it. Should the Bank at any time choose not to accept gold, the Chamber of Mines is free to dispose of this excess as it sees fit. In the interest of the mining companies, the Chamber may well decide to sell where it can get the best price.

[redacted] 25X1

[redacted] The close family ties maintained by the Chinese in Hong Kong with other Chinese throughout Asia also have facilitated Hong Kong's functioning as a regional gold market. 25X1

13. Prior to the establishment of the two-tier gold market, gold legally flowing into Hong Kong came from London (about 50 percent) and Australia (40 percent), with most of the remainder coming from Canada. [redacted] In addition to these legal imports, undetermined amounts have been smuggled into Hong Kong from the Middle East, especially since the free market came into being. 25X1 25X1 25X1

14. Traditionally, legal imports into Hong Kong have been substantially smaller than supplies flowing through the large European and Middle Eastern markets, while prices have usually been a dollar or so higher (see Table 6), largely as a result of transportation costs. Throughout the mid-1960's, volume has ranged from 40 tons to 60 tons a year, or between 3.3 and 5.0 tons a month. Although a peak of 5 tons was purchased in March 1968, volume has since declined significantly, owing at least in part to reduced demand.

15. Three foreign exchange and investment firms -- Mount Trading Company, Commercial Investment Company, and Premex -- are licensed to import gold into Hong Kong for reexport only. For a standard fee of US $0.20 an ounce, these three firms pick up the gold at the airport or harbor and place it in their warehouses prior to reexport. All gold entering Hong Kong in this manner -- mostly bullion but some coins as well -- is eventually shipped the 40 miles to Macao* aboard hydrofoils of the Hong Kong-Macao

* *Small amounts equivalent to less than one-third of a ton are known to have been shipped to Sarawak (Borneo) in 1962 and to Laos and Thailand in 1964.*

Hydrofoil Company Ltd., a firm owned by the Sindicato de Ouro, the Macao gold syndicate.

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Table 1

Actual and Planned Transactions in Gold with the United States
September-December 1968

Million US $

Country	1-30 September		1-4 October		Planned Purchases from the US 5 October to End of Year
	Purchase from the US	Sale to the US	Purchase from the US	Sale to the US	
France		85.0			
Argentina	5.0		5.0		5.0
Philippines				5.0	
Burma	2.5				
Malta	2.5				
Ireland	1.0				
Mauritius	0.3				
Liberia	0.1				
Somalia	0.1				

Table 2

Price Range in the London and Zurich Gold Markets
2 September-4 October 1968

Week	London a/	Zurich b/
		US $ per Fine Ounce
2 - 6 Sep	39.90 to 40.10	38.80 to 40.25
9 - 13 Sep	40.00 to 40.25	39.85 to 40.40
16 - 20 Sep	40.20 to 40.55	39.95 to 40.65
23 - 27 Sep	40.125 to 40.475	40.20 to 40.60
30 Sep - 4 Oct	38.30 to 39.70	39.00 to 39.70

a. Based on morning and afternoon fixes.
b. Not exactly comparable with London; these data consist of the lowest offer to buy and the highest offer to sell during the week.

Table 3

Estimated Monthly South African Gold Sales
January-September 1968

Million US $

Month	Value	Month	Value
January	48	June	62
February	23	July	63 a/
March	22	August	78 a/
April	0	September	34 a/
May	0	*Total*	*330*

a. Includes known sales plus or minus discrepancies from sales implied by production and reserve data. (See Table 4 and paragraph 7 of text.)

Table 4

South African Gold Transactions a/
July-September 1968

		Million US $
July		
Reserves reported by South Africa, 30 June		975
Reported production for July		91
Total estimated reserves before sales		1,066
Known sales		34
1 July: To Portuguese Central Bank (30 tons)	34	
Estimated reserves after known sales		1,032
Reserves reported by South Africa, 31 July		1,003
Discrepancy b/		29
August		
Reserves reported by South Africa, 31 July		1,003
Estimated production for August		91
Total estimated reserves before sales		1,094
Known sales		91
5 August: To Portuguese Central Bank (40 tons)	45.0	
7 August: To Swiss commercial banks (8.5 tons)	9.6	
16 August: To Swiss commercial banks (8.5 tons)	9.6	
21 August: To Swiss commercial banks (8.5 tons)	9.6	
21 August: To Portuguese Central Bank (15 tons)	16.9	
Estimated reserves after known sales		1,003
Reserves reported by South Africa, 31 August		1,016
Discrepancy b/		-13
September		
Reserves reported by South Africa, 31 August		1,016
Estimated production for September		91
Total estimated reserves before sales		1,107
Known sales		42
3 September: To Swiss commercial banks (11.4 tons)	12.8	
11 September: To Swiss commercial banks (11.4 tons)	12.8	
16 September: To Portuguese Central Bank (15.0 tons)	16.9	
Estimated reserves after known sales		1,065
Reserves reported by South Africa, 27 September		1,064
Adjustment to 30 September		9
Adjusted South African reserves, 30 September		1,073
Discrepancy b/		-8

a. Because of rounding, components may not add to the totals shown.
b. Most of the "discrepancies" shown probably are due to irregularities in the flow of gold from production -- which is fairly stable on a month-to-month basis -- into reserves. This judgment is based on analysis of production data and reserve data for the January-July period.

Table 5

Estimated South African Quarterly Balance of Payments
1968

Million US $

	First Quarter	Second Quarter	Third Quarter (Estimated)	Fourth Quarter (Forecast)	Total
Current account (excluding gold)					
Merchandise exports, f.o.b.	555	550	490	465	2,060
Merchandise imports, f.o.b.	-665	-670	-665	-665	-2,665
Trade balance	-110	-120	-175	-200	-605
Net service and transfer payments	-75	-95	-95	-95	-360
Balance on current account	-185	-215	-270	-295	-965
Net capital movements	178	110	60	60	408
Balance on current and capital account	*-7*	*-105*	*-210*	*-235*	*-557*
Financing of deficit	7	105	210	235	557
Gold sales (monetary and nonmonetary)	93	62	175	N.A.	N.A.
Change in net foreign exchange assets and residual (negative sign indicates an increase in assets, a positive sign a decrease)	+86	-43	-35	N.A.	N.A.

Table 6

Gold Bullion Imports into Hong Kong
1966 - June 1968

Year and Month	Quantity (Metric Tons)	Price (US $ per Fine Ounce)
1966 (monthly average)	3.6	36.08
1967 (monthly average)	4.6	36.76
1968		
January	3.0	35.48
February	1.5	35.53
March	5.0	36.26
April	1.8	37.95
May	1.4	42.61
June	0.6	41.77